Supreme Court of the United States

PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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IN THE

Supreme Court of the United States

October Term, A. D., 1960

No._____

TENNESEE LIFE INSURANCE COMPANY, *Petitioner*

v.

R. L. PHINNEY, DISTRICT DIRECTOR OF INTERNAL REVENUE AT AUSTIN, TEXAS, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner Tennessee Life Insurance Company, a Texas corporation, prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Fifth Circuit in this cause (No. 18,160 below) affirming the judgment of the United States District Court for the Western District of Texas. Petitioner respectfully shows unto the Court:

I.

Opinions of the Courts Below

The majority and dissenting opinons of the Court of Appeals (R. 71), appended hereto as Appendix B, infra, p. 27, are reported at ____F. 2d ____.[1]

The Findings of Fact and Conclusions of Law entered by the United States District Court for the Southern District of Texas are set fourth at pp. 52-60 of the Record, but are not officially reported.

II.

Grounds on Which the Jurisdiction of This Court Is Invoked

(a) The judgment of the Court of Appeals was entered on June 13, 1960 (R. 82), and was issued as and for the mandate of the Court of Appeals on August 4, 1960.

(b) The order of the Court of Appeals denying the petition for rehearing filed in the case was entered on July 15, 1960 (R. 99).

(c) Jurisdiction of this cause is conferred upon this Court by U.S.C. 1958 ed., Title 28, § 1254 (1), p. 5014.

III.

Questions Presented for Review

The primary question presented for review in this case is:

Whether a deduction for ad valorem taxes which under the Internal Revenue Code of 1939 could not be allo-

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[1] The conflicting decision of the United States Court of Appeals for the Sixth Circuit in **Simon J. Murphy Co. v. Comm'r.**, 231 F.2d 639 (1956), relied upon herein as a basis for certiorari, is appended hereto for convenience as Appendix C, infra, p. 40.

cated between unrelated taxpayers may under Sec. 45 of the Internal Revenue Code of 1939 be allocated between *related* taxpayers.[2]

A subsidiary question is:

Whether an accrual basis taxpayer, owning realty on the date current ad valorem taxes become a lien thereupon and the personal liability of such taxpayer, may accrue such taxes where such taxpayer disposes of the realty in question before the assessments of such taxes are entered on the tax rolls.

IV.

Statutes and Regulations Involved

The principal statute to be construed is Sec. 45, Internal Revenue Code of 1939. Sec. 482 of the Internal Revenue Code of 1954 is substantially identical with it. § 39.45-1 of Regulations 118 is the regulation directly involved. Such statutes and regulations, and the other statutes less directly involved are all set forth verbatim in Appendix A hereto, infra, pp. 17-26.[3] All such statutes and regulations are cited as follows:

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[2] Whereas Sec. 164 (d)(1) of the Internal Revenue Code of 1954 permits apportionment of ad valorem taxes on realty between sellers and purchasers, such apportionment is limited to circumstances where the realty is **sold.** Thus, the question here presented is equally applicable under the Internal Revenue Code of 1954 to ad valorem taxes imposed on real property where disposition thereof after the taxing date occurs, as in the instant case, other than through a **sale.**

[3] Various statutes of the State of Texas and ordinances of the City of Houston, Texas were originally submitted solely to show the fixation of January 1 of each year as the date of lien and personal liability for taxes in Texas. These statutes are not here set forth because of the recognition given to and admission of this circumstance by the Court of Appeals in its opinion, Appendix B, infra, pp. 29 and 32.

U.S.C. 1952 ed., Title 26 (Internal Revenue Code of 1939, as amended), § 23 (c), p. 3295; § 41, p. 3317; § 43, p. 3319; § 45, p. 3320; § 47(g), p. 3321; § 48 (a), p. 3322; § 122, pp. 3382-3384; § 311, p. 3464.

U.S.C. 1958 ed., Title 26 (Internal Revenue Code of 1954), § 164a, p. 4287; § 164 (d) (1), p. 4287; § 482, p. 4368.

Code of Federal Regulations, Title 26, Part 39, Revised 1953 (Regulations 118, Income Tax), § 39.45-1, pp. 520-521.

V.

Statement of the Case

a. *Jurisdiction*

This action was brought to recover certain income taxes assessed against Building Corporation for 1952 which were paid by petitioner. Original jurisdiction was vested in the District Court of the United States under U.S.C. Title 28, § 1340, and venue was laid under the U.S.C. Title 28, § 1391(b) in the judicial district in which defendant R. L. Phinney resided. The cause was tried upon petitioner's complaint (R. 1), respondent's answer (R. 7), respondent's request for admission of facts (R. 11) and the amendment thereto (R. 15), petitioner's response thereto (R. 16) and the objections of petitioner to certain of such requests (R. 22), the stipulation of facts and the exhibits thereto (R. 25) and the additional stipulation (R. 46).

Following entry of the judgment of the District Court dismissing petitioner's complaint on October 16, 1959 (R. 49), petitioner filed its notice of appeal to the United

States Court of Appeals for the Fifth Circuit on October 24, 1959 (R. 50), and jurisdiction vested in such Court under U.S.C. Title 28, § 1291.

b. *Material Facts*

This case involves the taxable income of Tennessee Gas Building Corporation (Building Corporation) for its taxable year which began January 1, 1953 and ended with its dissolution on January 23, 1953 (herein referred to as the "short year 1953"). Tennessee Life Insurance Company (Life Company), petitioner herein, brings this action and is an actor herein only because it, as the transferee of the assets of Building Corporation on its liquidation and dissolution, paid the taxes for which refund has been claimed in this proceeding (R. 52).

Building Corporation from the inception of its organization to January 19, 1953 was a wholly owned subsidiary of Tennessee Gas Transmission Company, herein called TGT (Stip. par. 2, R. 26). Life Company was organized on November 25, 1952, and from its inception this corporation has been a wholly owned subsidiary of TGT (Stip. par. 1, R. 25). On January 19, 1953, TGT transferred the capital stock of Building Corporation to Life Company as a contribution to its capital. Thereafter on January 19, 1953, Building Corporation adopted a plan of liquidation and dissolution under which, on that date, Building Corporation transferred all of its assets, subject to its liabilities, to Life Company. Building Corporation was thereafter formally dissolved on January 23, 1953 (Stip. par. 5, R. 26).

On January 1, 1953, Building Corporation was the owner of the Commerce Building and certain other proper-

ties situated in Houston, Texas (Stip. par. 6, R. 27). In 1953 an official of Building Corporation rendered the Commerce Building in the name of Building Corporation. Pursuant to such rendition, the ad valorem taxes for the year 1953 on the Commerce Building were assessed to Building Corporation (Stip. par. 12, R. 28). State of Texas and Harris County and City of Houston and Houston Independent School District ad valorem taxes for the calendar year 1953 totalling $143,570 were assessed to Building Corporation in respect of the properties which it owned on January 1, 1953 (Stip. par. 6, R. 27). These taxes are shown on Exhibit C attached to the stipulation (R. 45).

Building Corporation throughout its existence maintained its books of account and reported its taxable income on the accrual basis of accounting (Stip. par. 7, R. 27). On December 31, 1951 and December 31, 1952, the close of Building Corporation's taxable years 1951 and 1952, respectively, there was accrued as a liability on the books of account of Building Corporation the respective ad valorem taxes assessed against its properties for the calendar years 1951 and 1952 (Stip. par. 9, R. 28). During each of those taxable years 1951 and 1952, Building Corporation made monthly entries on its books of account for the pro rata estimated expenses for ad valorem taxes of each monthly period. Monthly statements of profit and loss of Building Corporation, reflecting the entries made to its books of account were prepared, but were not communicated to any third party or published (Stip. par. 10, R. 28).

On January 19, 1953, just prior to its liquidation, there was accrued on the books of account of Building Corporation as an estimated liability the amount of $152,340 for

ad valorem taxes which would be assessed for the calendar year 1953 against the Commerce Building and other properties which Building Corporation held on January 1, 1953. The amount of such ad valorem taxes actually assessed was $143,570 which represented ad valorem taxes assessed by the State of Texas, Harris County, the City of Houston and the Houston Independent School District. The assessments were entered on the tax rolls by the appropriate officials subsequent to January 23, 1953 (Stip. par. 8, R. 27).

Building Corporation did not itself actually pay the ad valorem taxes of $143,570 assessed against it for the calendar year 1953. Upon its liquidation, Building Corporation transferred to Life Company funds out of which such ad valorem taxes could have been paid (Stip. par. 13, R. 29).

Life Company caused Building Corporation to file corporate income tax returns for its taxable calendar year 1952, and for the short year 1953, that is the taxable year commencing January 1, 1953 and ending with the dissolution of Building Corporation on January 23, 1953. In the return for the short year 1953, Building Corporation reported the rentals paid by Commerce Building tenants for the entirety of the month of January and claimed a deduction for the total amount of $143,570 of 1953 ad valorem taxes which were assessed in 1953 against the properties Building Corporation owned on January 1, 1953. In the return for the short year 1953 Building Corporation claimed a net operating loss principally as a result of the ad valorem taxes which it deducted therein (Fdgs. pars. 17 and 18, R. 37).

The 1952 income tax return of Building Corporation showed a tax liability of $61,158.34, after deducting from the taxable income set forth on such return as a net operating loss carry-back the amount of the net operating loss shown on the return for the short year 1953. Subsequently the net operating loss deduction claimed by Building Corporation on said return for 1952 was disallowed by respondent, and the resulting deficiency assessment of $43,417.40 plus interest was paid on March 6, 1956 (Fdgs. pars. 17 and 18, R. 57). This suit was brought for refund of that deficiency assessment.

In disallowing the net operating loss deduction claimed by Building Corporation on its 1952 return, the respondent allowed as a deduction on the return of Building Corporation for the short year 1953 only $7,080 as a deduction for ad valorem taxes in that year. Such amount represented 18/365 (representing the 18 day period during 1953 preceding the liquidation of Building Corporation on January 19, 1953) of the total amount of $143,570 of Texas ad valorem taxes assessed in 1953 against the properties owned by Building Corporation on January 1, 1953 (Fdgs. par 20, R. 58).

Substantially these same facts were recited as the material facts by the Court of Appeals in its decision; Appendix B, infra, pp. 27 through 30.

VI.

Reasons Relied on for the Allowance of the Writ

There are three compelling reasons why review on writ of certiorari should be granted in this case. They are as follows:

1. The majority decision of the Court of Appeals is in direct and admitted conflict with the decision of the Court of Appeals for the Sixth Circuit in the case of *Simon J. Murphy Co. v. Comm'r.*, 231 F. 2d 691 (1956).

2. The majority decision of the Court of Appeals is in conflict with the decision of this court in *Magruder v. Supplee*, 316 U.S. 394 (1942).

3. The majority decision of the Court of Appeals entirely abrogates the historic standard of arm's length conduct between uncontrolled taxpayers prescribed by the Commissioner of Internal Revenue to be followed in the administration of Sec. 45, Internal Revenue Code of 1939. Because of the consequences of such abrogation on the administration of the substantially identical Sec. 482 of the Internal Revenue Code of 1954, the majority decision presents an extremely important question of Federal law not heretofore considered by this Court.

1. *Conflict With Sixth Circuit Decision.*

The decision of the majority of the Court of Appeals is in direct and admitted conflict with the decision of the Court of Appeals for the Sixth Circuit in the case of *Simon J. Murphy Co. v. Comm'r.*, 231 F. 2d 639 (1956), Appendix C, infra, p. 40. Admission of this conflict is noted in the majority opinion as follows:

> "We are constrained to agree with the position taken by the Commissioner supported by the judgment of the Trial Court. In concluding as we do we recognize that we must differ, however reluctantly, with the decision

of the Court of Appeals for the Sixth Circuit in *Simon J. Murphy Co. v. Comm'r.*, 6 Cir., 231 F.2d 639."

The opinion of the dissent in the Court of Appeals even more succinctly points out this conflict. It is there stated as follows:

"The Court of Appeals for the Sixth Circuit had before it a case identical with this one in the legal principles involved, *Simon J. Murphy Co., Etc. v. Commissioner of Internal Revenue*, 1956, 231 F.2d 639. The Commissioner raised every point in that case which appellee relies upon here and every point was decided in favor of the taxpayer. It is the only case cited by either party which applies to the facts before us. The majority declines to follow the Murphy case, but I find its reasoning unanswerable and we should follow it."

The conflict of the majority in the instant case with the decision in the *Murphy Co.* case exists on two broad fronts. First, the majority here held that Sec. 45 of the Internal Revenue Code of 1939, permitting the Commissioner to allocate income and deductions between related taxpayers, permits the allocation to a related taxpayer of a deduction it would not be legally entitled to claim if unrelated. The Court stated:

" * * * we are satisfied that the right of the Commissioner to apportion or distribute deductions or income under Section 45 is not restricted to such apportioning or distribution as would be permissible for two unrelated taxpayers under existing taxing statutes." Appendix B, infra, p. 35.

In so holding, the majority abrogated the standard of arm's length conduct between uncontrolled taxpayers prescribed by the Commissioner for the administration of Sec. 45 from the inception of the appearance of that section in the income taxing statutes. The importance of this matter will be more fully discussed under point 3 of these reasons.

Second, the majority held the fact that Texas ad valorem taxes become a lien and become the personal obligation of the owner of realty on January 1 of each year does not mean that such taxes may be accrued as a deduction for income tax purposes as of such date. In the *Murphy Co.* case the ad valorem taxes also became a lien on the properties there in question and a debt of the owner thereof on January 1, and accrual was held to be proper. The Court of Appeals in the instant case reasons that accrual is improper because the taxes were not finally determined in amount or formally entered on the tax rolls until after dissolution of Building Corporation on January 23.

The Commissioner has consistently recognized the lien date of ad valorem taxes as the date of their accrual for the purpose of denying any deduction for such taxes to any party other than the owner of the property on the lien date. In GCM 6272, VIII-1 Cum. Bul. 170, which ruling has never been revoked or questioned, the Commissioner held January 1 to be the accrual date of ad valorem taxes in Texas, even though he recognized that the amount of the taxes was not "ascertainable on that date."

Ad valorem taxes in Texas are assessed for the calendar year in which on January 1 they become a lien. Building Corporation maintained its records on a calendar year accrual basis. Petitioner has never denied that

Building Corporation for purposes of its internal accounting records during 1951 and 1952 charged to expense each month one-twelfth of its estimated ad valorem tax liability for each such calendar year, adjusting its accounting records at the end of each such accounting year to reflect its actual ad valorem tax liability for that year. Thus, in each one of those calendar years 1951 and 1952, Building Corporation accrued that particular calendar year's ad valorem taxes. Obviously no part of the 1953 taxes could be apportioned back to the year 1952. If *Building Corporation* was to obtain a deduction for the 1953 taxes, the only period in which it could obtain such a deduction was in its short year 1953 ending with its dissolution on January 23, 1953. In *Citizens Hotel Co. v. Commissioner*, 127 F. 2d 229 (5th Cir., 1942) and *Allen v. Atlanta Stove Works, Inc.*, 138 F.2d 452 (5th Cir., 1943), relied upon by the majority in the instant case, there was no disposition of the property in question and the only point for decision was to determine the proper year of a single taxpayer for the deduction of the taxes. Here there was a disposition of the property and of it the dissenting judge said:

> "There is no contention that the transaction here involved was not bona fide in every respect and that it did not serve a useful purpose."

The short year 1953 was a taxable year. Secs. 47(g) and 48(a), Internal Revenue Code of 1939, Appendix A, infra, pp. 18 and 19. Consistent with its practices in its taxable years 1951 and 1952, Building Corporation at the end of its short year 1953 accrued its liability for the entirety of the 1953 taxes. If Building Corporation had sold the property within its short year 1953 to an en-

tirely unrelated party and then dissolved, denial to it during its short year 1953 of the right to accrue the ad valorem taxes would simply have amounted to a denial of a deduction for such taxes. Denial of the accrual where the properties were distributed in liquidation to a related party is similarly simply a denial of a deduction for the taxes unless allocation thereof under Sec. 45 shall be permitted.

2. *Conflict with this Court's decision:*

The decision of the majority of the Court of Appeals directly conflicts with the decision of this Court in *Magruder v. Supplee*, 316 U.S. 394 (1942) wherein this Court held that ad valorem taxes on realty could be deducted *only* by the person owning the realty on the date such taxes became a lien against it and a liability of such owner.

In his *press* for application of the rule of the *Magruder v. Supplee case*, the Commissioner of Internal Revenue has heretofore denied any deduction claimed by a *related successor owner* for ad valorem taxes which became a lien against the property in the hands of a predecessor. His position was upheld by the Board of Tax Appeals in two cases involving Texas ad valorem taxes. In *Texas Coca Cola Bottling Co. v. Commissioner*, 30 BTA 736 (1934), the parties were intensely related. Partnership properties were transferred to a corporation in a transaction upon which the Court held no gain or loss was recognized to the transferors. Yet the successor corporation was denied any deduction for the taxes it paid on properties acquired March 1, which were subjected to the tax lien on the prior January 1. Again in *American Liberty Oil Co. v. Commissioner*, 43 BTA 76 (1940), the properties were acquired in May in a non-taxable reorganization, but the

successor corporation was denied any deduction for the taxes it paid which became a lien on the preceding January 1 on the transferred properties.

3. *Substantive Importance of the Decision of the Court of Appeals*

The standard of arm's length conduct between unrelated parties prescribed by the Commissioner for the administration of Sec. 45 has been abrogated by the majority decision of the Court of Appeals. In their citation of *Jud Plumbing & Heating, Inc. v. Comm'r.*, 153 F. 2d 681 (5 Cir., 1946) and *Dillard Waltermire, Inc., v. Campbell*, 255 F.2d 433 (5 Cir., 1958), as support for this proposition, the majority misconceive the nature of the allocation made in those cases. In both, a portion of the income realized by a related successor party upon the completion of contracts, transferred to the successor while work thereon was in progress by the predecessor organization, was allotted to the predecessor organization. This action recognizes only the fact that an arm's length purchaser of such contracts would have made a payment of the actual worth of the work done thereupon by the predecessor organization. The cases supply no suggestion that arm's length standards between unrelated parties may be violated by allocation to a related successor organization of a deduction denied by law to any party other than its predecessor.

This arm's length standard has been prescribed under the income tax regulations from the inception of Regulations 86 (1934), the first to deal with Sec. 45 of the Revenue Acts, through all of the intervening regulations down through Regulations 118 (1953). Under section 45-1, subdivision (a)(6) has provided as follows:

"The term 'true net income' means, in the case of a controlled taxpayer, the net income (or as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement or other act) *dealt with the other member or members of the group at arm's length.*" (Emphasis supplied)

Subdivision (b) (1) has provided:

"The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. * * * *The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.*" (Emphasis supplied)

The last sentence of subdivision (c) has provided as follows:

"The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been *an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.*" (Emphasis supplied)

Thus the Congress, time after time, has re-enacted Sec. 45 of the Revenue Acts and the Internal Revenue Code in the light of regulatory specifications

which required its provisions to be administered according to the standards "of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Language substantially identical with that found under Sec. 45 of the Internal Revenue Code of 1939 is contained under Sec. 482 of the Internal Revenue Code of 1954. Regulations under that Section of the Internal Revenue Code of 1954 have not yet been promulgated. Allowing the decision of the majority of the Court of Appeals in the instant case to stand will constitute a mandate to the Commissioner of Internal Revenue to ignore and omit this standard of arm's length conduct when he proposes those regulations.

Conclusion

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Internal Revenue Code of 1939.

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

* * *

"(c) Taxes Generally.

(1) Allowance in General.—Taxes paid or accrued within the taxable year, * * *"

"Sec. 41. GENERAL RULE.

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year."

"Sec. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

"The deductions and credits (other than the corporation dividend paid credit provided in section 27) provided for

in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing net income for the period in which falls the date of the taxpayer's death."

"Sec. 45. ALLOCATION OF INCOME AND DEDUCTIONS.

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

"Sec. 47. RETURNS FOR A PERIOD OF LESS THAN TWELVE MONTHS.

"* * *

"(g) Returns Where Taxpayer Not in Existence for Twelve Months.—In the case of a taxpayer not in existence during the whole of an annual accounting period ending on

the last day of a month, or, if the taxpayer has no such annual accounting period or does not keep books, during the whole of a calendar year, the return shall be made for the fractional part of the year during which the taxpayer was in existence."

"Sec. 48. DEFINITIONS

"When used in this chapter—

"(a) Taxable Year.—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. "Taxable year" means, in the case of a return made for a fractional part of a year under the provisions of this chapter or under regulations prescribed by the Commissioner with the approval of the Secretary, the period for which such return is made.

* * *

"Sec. 122. NET OPERATING LOSS DEDUCTION.

"(a) Definition of Net Operating Loss.—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

"(b) Amount of Carry-Back and Carry-Over.—

"(1) Net Operating Loss Carry-Back.—

"(B) Loss for Taxable Year Beginning After 1949.—

If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for the preceding taxable year.

"(c) Amount of Net Operating Loss Deduction.—The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d), (1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income (computed without such deduction and without the credits provided in section 26(h) and (i);

"(d) Exceptions, Additions, and Limitations.—The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

"(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114(b), (2), (3), or (4);

"(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23(b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax exempt obligations;

"(3) No net operating loss deduction shall be allowed;

"(4) The amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from such sales or exchanges. The deduction provided in section 23(ee) shall not be allowed.

"(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carcarried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions and limitations specified in paragraphs (1) to (4) of this subsection. This paragraph shall not apply with respect to deductions allowable for losses sustained after December 31, 1950, in respect of property, if the losses arise from fire, storm, shipwreck, or other casualty, or from theft."

"* * *

"(e) No Carry-Back to Year Prior to 1941.—As used in this section, the term "preceding taxable year" and the term "preceding taxable years" do not include any taxable year beginning prior to January 1, 1941."

"Sec. 311. TRANSFERRED ASSETS.

"(a) Method of Collection.—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of deliquency in payment after notice and demand, the provisions, authorizing distraint and proceedings in courts for collection, and the provisions prohibiting claims and suits for refunds):

"(1) Transferees.—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions

to the tax provided by law) imposed upon the taxpayer by this chapter.

"* * *

Any such liability may be either as to the amount of tax shown on the return or as to any deficiency in tax."

Internal Revenue Code of 1954

"Sec. 164. TAXES.

"(a) General Rule. — Except as otherwise provided in this section, there shall be allowed as a deduction taxes paid or accrued within the taxable year.

* * *

"(d) Apportionment of Taxes on Real Property Between Seller and Purchaser.—

(1) General Rule.—For purposes of subsection (a), if real property is sold during any real property tax year, then—

(A) so much of the real property tax as is properly allocable to that part of such year which ends on the the day before the date of the sale shall be treated as a tax imposed on the seller, and

(B) so much of such tax as is properly allocable to that part of such year which begins on the date of the sale shall be treated as a tax imposed on the purchaser.

* * *

"Sec. 482: ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses."

Regulations 118, promulgated under the Internal Revenue Code of 1939.

(Code of Federal Regulations, Title 26, Revised 1953, Part 39)

"*Sec. 39.45-1 Determination of the taxable net income of a controlled taxpayer—(a) Definitions.* When used in this section:

"(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Internal Revenue Code or regulations in this part), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

"(2) The terms "trade" or "business" include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

"(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

"(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

"(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

"(6) The term "true net income" means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

"(b) *Scope and purpose.* (1) The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

"(2) Section 45 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate net income. If a controlled taxpayer is a party to a consolidated return, the true consolidated net income of the affiliated group and the true separate net income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

"(3) Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right

to compel the Commissioner to apply such provisions. It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated net income under section 141.

"(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

APPENDIX B

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 18160

TENNESSEE LIFE INSURANCE COMPANY,
Appellant,

versus

R. L. PHINNEY, District Director of Internal Revenue at Austin, Texas,
Appellee.

Appeal from the United States District Court for the Western District of Texas.

(June 13, 1960.)

Before TUTTLE, CAMERON and JONES, Circuit Judges.

TUTTLE, Circuit Judge: This appeal tests the correctness of the Internal Revenue Commissioner's denial of a deduction of real estate taxes to one of two

wholly owned subsidiaries under the provisions of Section 45 of the Internal Revenue Code of 1939 as Amended, 26 U.S.C.A., Internal Revenue Code of 1939, §45, when the owner corporation, on January 1st, the date the lien for taxes attached, conveyed the property under a liquidation on January 19th to the second wholly owned subsidiary corporation.

The facts are not in dispute. On January 1, 1953, Tennessee Gas Transmission Corporation (T.G.T.) owned two subsidiaries, Tennessee Gas Building Corporation (Building Company) and Tennessee Life Insurance Company (Life Company). On that date Building Company was the owner of the Commerce Building in Houston, Texas. The Life Company was a "life insurance company" within the meaning of the Internal Revenue Code of 1939. On January 19, 1953, T.G.T. transferred all of the outstanding capital stock of Building Company to the Life Company as a contribution to capital. On the same day Building Company adopted a plan of complete liquidation and dissolution under which, on that date, it transferred all of its assets, subject to its liabilities, to Life Company. It was formally dissolved on January 23, 1953.

It was stipulated between the parties:

> "During each of its said taxable years 1951 and 1952, Building Corporation made monthly entries on its books of account for the pro-rata estimated expenses for ad valorem taxes of each such monthly period. Monthly statements of profit and loss of Building Corporation, reflecting the entries made to its books of account, were prepared, but were not communicated to any third party or published."

On January 19, 1953, just prior to its liquidation, there was entered on the books of account of Building Corporation an estimated liability of $152,340 for ad valorem taxes which would be assessed for the calendar year 1953 against the properties held by it on January 1, 1953. The amount of such ad valorem taxes later actually assessed was $143,570. Although the assessments were not made until sometime subsequent to January 23rd, it is not disputed that under the Texas law 1953 ad valorem taxes became a lien on the property and became the personal liability of the owner of the property on January 1st of that year.

In the tax returns filed by Building Company for the short year commencing January 1st and ending on January 23, 1953, Building Company reported income represented by rents from tenants of the Commerce Building for the month of January, 1953. It claimed a deduction of the total amount of $143,570 of ad valorem taxes assessed in 1953 for that calendar year.[1] Building Company claimed a net operating loss for the short year, principally as a result of the large item of a year's ad valorem taxes when matched against one month's income from the building.

The Commissioner adjusted Building Company's return for the short year 1953 by adjusting the rentals so as to include 18/31sts thereof and by allowing a deduction for ad valorem taxes in the amount of $7,080. This represented 18/365ths of the total amount of $143,570 of ad valorem taxes for the year 1953.

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[1] "Sec. 23. Deduction from Gross Income.
In computing net income there shall be allowed as deductions:"

"(c) Taxes Generally.
(1) Allowance in general.—Taxes paid or accrued within the taxable year

Thereafter, Life Company, as transferee of Building Company, filed a claim for refund of income taxes paid in respect to Building Company's taxable year 1952 on the ground that Building Company had sustained a net operating loss for the short year 1953, and was thus entitled to carry the loss back to 1952. This claim was disallowed, and this suit for refund followed.

The District Court sustained the Commissioner, holding that the adjustments as made were warranted under the provisions of Section 45 of the Internal Revenue Code of 1939 in order clearly to reflect the income of the two wholly owned subsidiaries.

Appellant here argues that until modified by the provisions of the 1954 Internal Revenue Code[2] only the taxpayer that owned real property on the date a particular year's taxes became a lien or became the personal obligation of the taxpayer could take a deduction for ad valorem taxes; that, therefore, as between non-associated taxpayers, dealing at arm's length, it would not be possible for the transferee, here represented by the Life Company, to take a deduction for that part of the real estate taxes corresponding with that part of the year 1953 following the transfer on January 19th; therefore, the Commissioner's attempt to "allocate" the ad valorem taxes by disallowing all but 18/365ths of the 1953 taxes amounted to a disallowance of much the greatest part of the tax deduction rather than an allocation as between the Building Company and the Life Company. This follows, appellant contends, since, under the 1939 Code, only the taxpayer of record on January 1st could take a deduction for real estate taxes, the Commissioner

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[2] See 26 U.S.C.A. §164 and §461(c)(1).

did not have the power to give this deduction to the transferee corporation under the allocation section.

The government does not dispute the basic premise, that is, under the 1939 Code where two unrelated corporations dealt with real property in Texas during an ad valorem tax year (here the calendar year 1953), the purchaser of the property could not take as a deduction any amounts which it paid to discharge the ad valorem tax lien against the property, whether such payment was made by it by agreement between the parties or in order to prevent a foreclosure of the tax lien. The Supreme Court case of *Magruder v. Supplee*, 316 U.S. 394, clearly establishes this proposition.

The government contends, however, that the authority granted to the Commissioner by Section 45 is intended to permit allocations as between related taxpayers when necessary to reflect the true income as between such taxpayers, even when the result of such allocation is to allocate either income or deduction to a taxpayer which, under other sections of the Internal Revenue Code, would not legally be entitled to give it such treatment. In other words, the Commissioner contends that the principle of *Magruder v. Supplee* is binding only *absent a reallocation of deductions* under the authority of Section 45.

We are constrained to agree with the position taken by the Commissioner and supported by the judgment of the trial court. In concluding as we do we recognize that we must differ, however reluctantly, with the decision of the Court of Appeals for the Sixth Circuit in *Simon J. Murphy v. Commissioner*, 6 Cir., 231 F. 2d 639.

In addition to the ground principally urged by the Commissioner and made the basis of the trial court's decision, we feel that we are bound by two previous decisions of this Court to conclude, contrary to the views of the Court in the Murphy case, that the Texas ad valorem taxes here involved were neither "paid or accrued" during the short tax year, except to the extent allowed by the Commissioner. These two cases are *Citizens Hotel Co. v. Commissioner of Internal Revenue*, 5 Cir., 127 F. 2d 229, a Texas case, and *Allen, Collector v. Atlanta Stove Works, Inc.*, 5 Cir., 138 F. 2d 452, a Georgia case involving the same state tax principles.

We think the basic error in the contention of the appellant is its assumption that because Texas ad valorem taxes became a lien and became the personal obligation of the Building Company on January 1, 1953, they "accrued" on that date. We have expressly held to the contrary in Citizens Hotel Company, *supra*. It is undisputed that the taxes were not "paid" during the short year. The only other basis for Building Company's right to deduct them, therefore, would be their "accrual" prior to January 19, 1953. We think it clear that the terms "pay or accrue" relate to the method of accounting used by a taxpayer. In order for a *cash* basis taxpayer to be permitted to deduct taxes he must have actually paid them during the tax year. In order for an *accrual* basis taxpayer to be permitted to deduct them, he must, under the accrual system of accounting, accrue them on his books. Here, to be sure, Building Company entered the estimated amount of the entire 1953 ad valorem taxes on its books prior to dissolution on January 23rd. This, however, was inconsistent with the accrual method of accounting which tax-

payer had followed in the previous years of its existence. It is stipulated that during the years 1951 and 1952 taxpayer accrued 1/12th of the estimated ad valorem tax on its books each month. This is strictly in accord with the accrual method of accounting as described in Judge Sibley's opinion in the Citizens Hotel Company case, *supra*. There the opinion stated:

> "The taxpayer's books are kept on a general accrual basis, and this annual tax charge is distributed by months over the year. The amount of it has to be estimated until the tax is determined, and an adjustment is made thereafter. This is conceded to be good accounting practice, and we think it clearly reflects the true income for a period less than a year."

In that case the Commissioner sought a holding that in Texas the entire ad valorem tax *accrued* on January 1st. We expressly rejected that proposition by stating:

> "It is true that in Texas property taxes are a personal liability of the owner measured by the value of the property which he owns on January 1. The assessments of values are made up at a later time in the year, as are the rates of County and City tax for the year, and then the amount of tax due by each taxpayer is arrived at and put on the tax rolls. The County tax rate was not fixed in this instance till August 16, 1937, and the City tax rate September 29, 1937. *If a strict date of accrual must be adhered to, it would have to fall after the tax rates were fixed; for* until then a necessary ingredient of the tax liability was lacking, and no tax demand could be formulated. But we think no such strict date can be insisted on. As is fully

> explained in United States v. Anderson, 269 U.S. 422, 46 S. Ct. 131, 133, 70 L. Ed. 347, the accrual basis for income tax returns was introduced to facilitate a true reflection of business incomes according to sound accounting principles; and the taxpayer's bookkeeping, if in accordance with such principles and truly reflecting net income, is allowed to be used as a basis of returns." (Emphasis added.)

In a Georgia case where the law as to the creation of a lien and the creation of the personal liability is identical with that in Texas, we held precisely the same thing in the Atlanta Stove Works case, *supra*. In an opinion, also written by Judge Sibley, this Court held:

> "Until his tax rate is fixed, the inchoate tax lien and debt cannot be said to have accrued."

Whatever may be understood under the Texas law to be the effect of the obligations and liabilities created as against real estate and its owners on January 1st, we think it clear that this Court has expressly held that there has been no "accrual" of an entire year's taxes in the sense in which the term is used in the Internal Revenue Code except as such taxes are "distributed by months over the year," since this is truly an accrual method of accounting. It is not disputed that this taxpayer was on an accrual basis.

We are thus forced to the conclusion that only such part of the annual tax burden for 1953 as would be shown to be due under the usual method of accounting adopted by Building Company comes within the deduction of "taxes paid or accrued" within the tax year.

Moreover, even on the broader ground, we are satisfied that the right of the Commissioner to apportion or distribute deductions or income under Section 45 is not restricted to such apportioning or distribution as would be permissible for two unrelated taxpayers under existing taxing statutes. This is implicit in the holding of this Court in *Jud Plumbing and Heating Co. v. Commissioner*, 5 Cir., 153 F. 2d 681, and Dillard-Waltermire, Inc., 5 Cir., 255 F. 2d 433. In both of those cases the taxpayer had consistently followed the "completed-contract" method of accounting. There was no doubt about the right of those taxpayers to follow that method of accounting. In fact, once having adopted that method they could not, without the consent of the Commissioner, change it. What the corporations did, in transferring partially completed contracts to related persons without accounting for any of the subsequently received payments on completion would thus have been required under the applicable statutes if the transferors and transferees had been unrelated persons. The transferor could not have reported the income which, under its accounting system, it had not become entitled to. But, since the control over the transferor and transferee in each case was held by one who could effect this obvious distortion of income, this Court held that Section 45 gave the Commissioner the power to reallocate the income in a way that unrelated parties could not have done.

We think the authority granted in Section 45 permits the Commissioner to deny to one of two related taxpayers such part of a deduction as is necessary to prevent the true taxable income to be distorted, and to allocate a deduction to a taxpayer which, absent the authority of Sec-

tion 45, would not be entitled to claim such deduction. There is nothing in the *Magruder v. Supplee* case that is inconsistent with this holding.

We, therefore, conclude that the judgment of the District Court was right. It is AFFIRMED.

CAMERON, Circuit Judge, Dissenting:

I respectfully dissent from the opinion of the majority affirming the judgment of the district court. The case of *Magruder v. Supplee*, May 1942, 316 U.S. 394, is, in my opinion, directly controlling in the case before us. This is inescapably true, unless it is the purpose of the tax officials that nobody shall receive the benefit of deduction of the large amount of taxes actually paid on this real property.

The Court of Appeals for the Sixth Circuit had before it a case identical with this one in the legal principles involved, *Simon J. Murphy Co., Etc. v. Commissioner of Internal Revenue*, 1936, 231 F.2d 639. The Commissioner raised every point in that case which appellee relies upon here and every point was decided in favor of the taxpayer. It is the only case cited by either party which applies to the facts before us. The majority declines to follow the *Murphy* case, but I find its reasoning unanswerable and I think we should follow it.[1]

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[1] That decision was rendered nearly two years before this action was begun and the Treasury Department failed to apply for certiorari, thus tacitly acquiescing in its holding.

The cases cited by the majority do not, in my opinion, apply to the facts before us nor tend to dilute the doctrines of *Supplee* and *Murphy*. There is no contention that the transaction here involved was not bona fide in every respect and that it did not serve a useful purpose. Upon principle and the authority of these two cases, I think the appellant is entitled to recover and that we should reverse the judgment of the district court and render one here in appellant's favor.

Citizens Hotel Co. v. Commissioner, 5 Cir., 1942, 127 F.2d 229; Allen, Collector v. Atlanta Stove Works, Inc., 5 Cir., 1943, 138 F.2d 452; Jud Plumbing & Heating Co. v. Commissioner, 5 Cir., 1946, 153 F.2d 681; and Dillard Waterfront, Inc., v. Campbell, Jr., District Director, 5 Cir., 1958, 255 F.2d 823.

JUDGMENT.

Extract from the Minutes of June 13, 1960

TENNESSEE LIFE INSURANCE COMPANY,

No. 18160. versus

R. L. PHINNEY, District Director of Internal Revenue at Austin, Texas.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

"Cameron, Circuit Judge, dissenting."

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 18,160

TENNESSEE LIFE INSURANCE COMPANY,
Appellant,

versus

R. L. PHINNEY, District Director of Internal Revenue at Austin, Texas,
Appellee.

Appeal from the United States District Court for the Western District of Texas.

(July 15, 1960)

ON PETITION FOR REHEARING

Before TUTTLE, CAMERON and JONES, CIRCUIT JUDGES.

PER CURIAM:

It is ORDERED that the petition for rehearing filed in the above styled and numbered cause be, and the same is hereby, DENIED.

"CAMERON, Circuit Judge, dissenting."

APPENDIX C

SIMON J. MURPHY COMPANY AND
Social Research Foundation, Inc.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

No. 12491.

United States Court of Appeals
Sixth Circuit.

April 2, 1956.

Proceeding by dissolved corporation and exempt, non-profit foundation against Commissioner of Internal Revenue on petition for review of decision of the Tax Court of the United States, 22 T.C. 1341, approving assessments of income tax deficiencies. The Court of Appeals, Shackelford Miller, Jr., Circuit Judge, held that, where foundation purchased all stock of corporate taxpayer, and transaction, by which corporation claimed, as deduction for income tax purposes, all real estate taxes which accrued on January 1, even though corporation had only an 11 day tax period for the year beginning January 1, was entered on books of foundation and corporation in accordance with approved accounting methods, and there was nothing in transfer of corporation's realty to foundation that could be successfully challenged, commissioner would not be permitted to allocate between corporation and foundation a net income different from that reflected in the books.

Judgment reversed, and case remanded for further proceedings consistent with opinion.

"

"Before Simons, Chief Judge, and Allen and Miller, Circuit Judges.

"Shackelford Miller, Jr., Circuit Judge.

The petitioners seek a redetermination of income tax deficiencies assessed by the Commissioner for the years 1949 and 1950. The assessments were approved by the Tax Court in the amount of $8,338.06 for year 1949 and in the amount of $6,094.84 for the year 1950, which ruling is now before us for review.

"The facts are stipulated and are summarized as follows: The Simon J. Murphy Company, hereinfter called Murphy Company, was a Michigan corporation which prior to its dissolution in 1950 owned and successfully operated several parcels of improved commercial real estate in downtown Detroit. It consistently prepared its corporate income tax returns on the accrual basis of accounting. Social Research Foundation, hereinafter called Social Research, is an exempt, non-profit foundation incorporated as such under the laws of Michigan.

"In 1949, Social Research acquired all of the outstanding capital stock of Murphy Company (126,000 shares), as follows: 3,900 shares were received as a gift from Charles B. G. Murphy; 30,800 shares were purchased from the estate of Fred T. Murphy at a price of $31.80 per share; and on December 29, 1949, 91,300 shares were purchased from the other stockholders at a price of $72.63 per share. Accordingly, Social Research became the sole shareholder of Murphy Company on December 29, 1949.

"On January 11, 1950, Murphy Company filed with the State of Michigan a certificate of dissolution there-

by completing its liquidation under and pursuant to a plan of Liquidation adopted on January 9, 1950, in the course of which Murphy Company transferred to Social Research all its real and personal property, subject to any and all debts and liabilities, which Social Research assumed and agreed to discharge, and Social Research surrendered to Murphy Company for complete cancellation and redemption all of the capital stock of that Company.

"Subsequent to the liquidation and pursuant to the Plan of Liquidation, City of Detroit real estate taxes in the amount of $227,077.32, and Wayne County real estate taxes in the amount of $41,666.07, on the transferred real estate were paid by Social Research in the total amount of $268,743.39. Copies of the tax bills, pursuant to which said payments were made, show the following assessed valuations of the transferred real estate: Marquette Building $402,990.00, Murphy Building $201,050.00, Telegraph Building $203,490.00 and Penobscot Building $6,011,680.00. The Penobscot Building was encumbered in 1928 with a mortgage to the Northwestern Mutual Life Insurance Company in the amount of $7,000,000.00, the unpaid balance being $2,540,000.00 on December 29, 1949.

"With certain minor or irrelevant exceptions all items of income and expense in connection with the ownership and operation of the transferred real estate were for tax and accounting purposes apportioned as to time between Social Research and Murphy Company as of January 11, 1950, except that the items of City of Detroit and Wayne County real estate taxes were accrued in their entirety as deductions by Murphy Company as of January 1, 1950. This treatment accorded with the past practice of Murphy Company in deducting real estate taxes in the taxable year when

they accrued and became a debt. It is not disputed that under the Michigan statute and Detroit Ordinance the real estate taxes *accrued* on January 1, 1950.

"In its final corporation income tax return filed on June 15, 1950, with respect to the taxable period January 1-11, 1950, Murphy Company included all rentals accruable during said taxable period, namely, $73,823.81. It deducted City of Detroit real estate taxes in the amount of $227,077.34, but did not deduct the Wayne County taxes. In its claim for refund and before the Tax Court it increased the deduction for real estate taxes to $268,743.39, so as to include Wayne County taxes.

"In order to protect itself against penalties for non-filing in the contingency that it was not ruled exempt, Social Research, on or about June 15, 1950 filed a corporate income tax return for the period April 19, 1949 through March 31, 1950, made upon the accrual basis. In this return it deducted real estate taxes in the amount of $58,876.91. It arrived at this figure by estimating the aggregate City of Detroit and Wayne County real estate taxes for the periods covered (the exact months being then unknown) and then prorating them on a time basis for the period January 12, 1950 through March 31, 1950.

"Based upon a deduction of $268,743.39 for real estate taxes Murphy Company sustained a net operating loss of $234,459.11 for the taxable period January 1 through 11, 1950. It thereafter filed a timely claim for refund with respect to over payment of its 1949 income taxes, which claim was based upon a net operating loss carry-back from the period January 1 through 11, 1950 in the amount of $234,459.11. Without formally ruling on the claim for refund the Commissioner subsequently determined the deficiencies in the 1949 and 1950 income taxes, which are the sub-

ject of this litigation. A deficiency assessment was also made against Social Research, as transferee. The assessments were based on the Commissioner's ruling that the City of Detroit taxes were allowable as a deduction in the 11-day period ended January 11, 1950 in amount not in excess of $6,843.42, and that the Wayne County taxes were allowable as a deduction for the same period in an amount not in excess of $1,255.69. This was an allocation of the taxes on the basis of 11/365ths to Murphy Company and 354/365ths to Social Research."

"In the Tax Court, petitioners challenged the right of the Commissioner to make such an allocation. They contended that the taxes became accrued liabilities on the part of Murphy Company on January 1, 1950 and under its accrual method of accounting were proper deductions in their entirety even though the corporation was dissolved on January 11, 1950. The Commissioner contended that the income of Murphy Company for the 11-day tax period in 1950 would be distorted and not clearly reflected if the Company was allowed to deduct the real estate taxes for 365 days while its income and other deductions reflected operations of only eleven days, and that he was authorized under Sections 41, 43 and 45 of the Internal Revenue Code, 26 U.S.C.A. §§41, 43, 45, to apportion or allocate the taxes between Murphy Company and Social Research in order to reflect clearly the income of each. The Tax Court held that the sections relied upon applied to deductions generally, including taxes; that section 45 applied even in the absence of fraud or deliberate tax avoidance; that the action of the Commissioner in allocating 11/365th of the total tax to Murphy Company for the 11-day period was proper; and that the allocation was also necessary to dissolve the fiction that the operation of the Company was unprofitable during the first eleven days of January 1950.

"The following well recognized principles are applicable to this case, concerning which the parties apparently have no dispute.

"(1) Section 23(c) (1), Internal Revenue Code of 1939, 26 U.S.C.A. §23(c) (1), provides that in computing net income there shall be allowed as deductions— "Taxes paid or accrued within the taxable year * * *." Where the taxpayer's books are kept on the accrual basis the taxes are deductible in the year of accrual rather than in the year in which they are paid. United States v. Anderson, 269 U.S. 422, 46 S. Ct. 131, Commissioner, 6 Cir., 111 F. 2d 330, certiorari denied, 311 U.S. 665, 61 S. Ct. 22, 85 L.Ed. 425; Commissioner of Internal Revenue v. Central United National Bank, 6 Cir., 99 F. 2d 568.

"(2) It logically follows from this general rule that the owner of real estate at the time when the real estate tax accrues, if he is on the accrual basis, is entitled to take the accrued tax as a deduction in the year in which it accrues, although it is not paid by him in that year. H. H. Brown Co., 8 B.T.A. 112, 117; Arcade Department Store, Inc., 18 B.T.A. 1172, 1177; Edward C. Kohlsaat, 40 B.T.A. 528; Cooledge, 40 B.T.A. 1325; Ohmer Register Co. v. Commissioner, 6 Cir., 131 F. 2d 682, 686, 143 A.L.R. 1164.

"(3) Petitioners contend that under United States v. Anderson, supra, 269 U.S. 422, 46 S. Ct. 131, 70 L.Ed. 347, and Magruder v. Supplee, 316 U.S. 394, 62 S. Ct. 1162, 86 L.Ed. 1555, the accrued taxes against the transferred real estate were properly charged as a tax liability and tax deduction against Murphy Company for its taxable year 1950 and that it could not be taken as a tax deduction in 1950 by Social Research even though the tax was later paid by Social Research. It was held in Magruder v. Supplee, supra, that when the owner of real estate against which a tax has accrued transfers title to a purchaser who thereafter pays the tax,

such payment by the purchaser can not be used by him as a deduction for income tax purposes, but must be considered as increasing the cost basis of the property purchased. The rule has been applied in this Circuit. Walsh-McGuire Co. v. Commissioner, 6 Cir., 97 F. 2d 983; Gilken Corp. v. Commissioner, 6 Cir., 176 F. 2d 141. In Magruder v. Supplee, supra, the Supreme Court refused to allocate any portion of the tax to the purchaser. This Court likewise refused to allocate any portion of the tax to the purchaser in Walsh-McGuire Co. v. Commissioner, supra. In Gilken Corp. v. Commissioner, supra, we approved and followed the ruling in Walsh-McGuire Co. v. Commissioner. Accordingly, we agree that the tax liability was on January 1, 1950 properly accrued on the books of Murphy Company as an income tax deduction for its taxable year 1950 and that a subsequent sale of the real estate to an independent purchaser in the regular course of business would not have cancelled this deduction or allocated any part of it to the purchaser.

"The controversy arises by reason of Sections 41, 43 and 45, Internal Revenue Code, 1939, under the provisions of which the Commissioner acted so as to change the result reflected by the taxpayer's books. The sections are related ones dealing with accounting methods, and for the purposes of this case Section 45 appears to be the one under which the Commissioner's action stands or falls. It was not involved in Magruder v. Supplee, supra, or in Walsh-McGuire Co. v. Commissioner, supra. It provides: "In any case of two or more organizations, trades, or businesses * * * owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to * * * apportion or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such * * * apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of

such organizations, trades, or businesses." To what extent, if any, Section 45 changes the rule of Magruder v. Supplee, supra, is the question presented.

"It should be noted in passing that the issue in this case will not exist in later taxable years, governed by the Internal Revenue Code of 1954. Section 164(d) of the 1954 Code, 26 U.S.C.A. §164(d), provides statutory authority for allocation of taxes on real property between the seller and purchaser.

"The background of the statute is important. The consolidated returns provision of the Internal Revenue Law was limited to corporations as distinguished from individuals or partnerships. It was recognized that there was among related businesses a considerable amount of arbitrary shifting of profits from one business to another, resulting in distortion of income and the avoidance of taxes. To remedy this situation Congress enacted in 1921 a consolidated accounts provision applicable to two or more related trades or businesses, whether incorporated or unincorporated. Its purpose was to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standards of an uncontrolled taxpayer, the true net income of the property and business of a controlled taxpayer. Section 45 had its origin in that legislation. Asiatic Petroleum Co. v. Commissioner, 2 Cir., 79 F. 2d 234, certiorari denied, 296 U.S. 645, 56 S. Ct. 248, 80 L. Ed. 459, rehearing denied, 296 U.S. 664, 56 S. Ct. 369, 80 L. Ed. 474; Welworth Realty Co., 40 B.T.A. 97; Mertens, Law of Federal Income Taxation, Vol. 8, Secs. 46.68-46.69.

"Litigation under the statute shows that the Section has been aplied to circumstances involving an improper manipulation of financial accounts, an improper juggling of the accounts between the related organizations, an improper "milking" of one business for the benefit of the other, or some similar abuse of proper

financial accounting, all made possible by the control of the two businesses by the same interests. When the Commissioner determined that a transaction between the controlled parties was not "at arm's length," an allocation would be justified in order to reflect the true net income which would have resulted if one uncontrolled taxpayer had dealt at arms length with another uncontrolled taxpayer. Substance has been substituted for form. Asiatic Petroleum Co. v. Commissioner, supra; Birmingham Ice & Cold Storage Co. v. Davis, 5 Cir., 112 F. 2d 453; National Securities Corp. v. Commissioner, 3 Cir., 137 F. 2d 600; Hugh Smith, Inc. v. C.I.R., 8 T.C. 660 affirmed, 6 Cir. 173 F. 2d 224; Advance Machinery Exchange v. Commissioner, 2 Cir., 196 F. 2d 1006; G.U.R. Co. v. C.I.R., 41 B.T.A. 223, affirmed, 7 Cir., 117 F. 2d 187; Welworth Realty Co., 40 B.T.A. 97.

"(4) There are numerous cases in which the action of the Commissioner in attempting to allocate net income between controlled organizations was held not justified under Section 45. The Commissioner may not create income, where none exists. Tennessee-Arkansas Gravel Co. v. Commissioner, 6 Cir., 112 F. 2d 508, 510; Texsun Supply Corp., 17 T.C. 433, 445. He may not disallow in its entirety a deduction authorized by other provisions of the Revenue Act. Hypotheek Land Co. v. Commissioner, 9 Cir., 200 F. 2d 390, 396. He may not combine or consolidate the separate income of two or more separate, although controlled organizations. Cedar Valley Distillery, Inc., 16 T.C. 870,876; Seminole Flavor Co., 4 T.C. 1215, 1232-1235. Where the two separate business entities, although owned or controlled by the same interests, deal with each other at arms length as they would deal with strangers in the respective courses of their business activities, allocation is not permitted. Koppers Co., T.C. 152; Palm Beach Aero Corp., 17 T.C. 1169; Friedlander Corp., 2[illegible] T.C. [illegible]; Briggs-Killian Corp., 40 B.T.A. 895; Essex

Broadcasters, Inc., 2 T.C. 523; Buffalo Meter Co., 40 T.C. 83; Epsen Lithographers v. O'Malley, D.C. Neb., 67 F. Supp. 181, 190-191.

"(5, 6) The foregoing cases point out the basic purpose of the statute to recognize the normal tax effect of bona fide business transactions between separate organizations, even though controlled by the same interests, but to enable the Commissioner to change the bookkeeping effect of a transaction between controlled taxpayers when, by reason of the relationship, they arbitrarily or improperly shift income or deductions from one organization to the other. As stated by the Tax Court, the application of Section 45 is not limited to cases of fraud. But, on the other hand, it does not automatically apply merely because the two organizations are controlled by the same interests. The Commissioner is not authorized to transfer income or deductions from one controlled organization to another, unless, by reason of the relationship the original distribution between the two entities, as reflected by the books, is in substance a fictitious one, improperly reflecting form instead of substance. In Koppers Co., supra, the Tax Court said 2 T.C. at page 157: 'It is true that the taxpayer here was a controlled corporation. Nothing, however, was taken from it or conveyed to it over and above what would have passed between petitioner and an uncontrolled corporation in a similar transaction.' In holding Section 45 inapplicable, the Tax Court further said, at page 158: 'Then followed the transaction under which these bonds were redeemed by the taxpayer and which respondent asserts resulted in a shifting of profits and was 'fictitious.' We find, however, nothing fictitious in the transaction. It was the same transaction, in so far as the consideration paid by the taxpayer for the redemption, as it would have been had it been carried out by the taxpayer with the public owners of the bonds prior to their acquisition by petitioner.'

"In the present case the transaction was a bona fide one. Since Social Research owned all the capital stock of Murphy Company, the consideration involved is not subject to attack as inadequate or fictitious. The transaction was entered on the books of the parties in accordance with approved established accounting methods. There was no juggling of accounts, no improper shifting of income or deductions from one company to the other, no 'milking' of one corporation for the benefit of the other, in fact there was nothing in the transfer of the real estate from one corporation to the other, and the accounting entries in connection therewith, that could have been successfully challenged by the Commissioner. The action of the Commissioner rests upon the dissolution of the selling corporation following the transfer. But the rule in Magruder v. Supplee, supra, under which an accrued tax liability of the vendor of real estate can not be treated as a tax liability of the vendee who later pays the tax, is not changed because the vendor is dissolved or liquidated after the transfer. Brudno v. Commissioner, 6 Cir., 138 F. 2d 779. Cf. Merchants' Bank Bldg. Co. v. Helvering, 8 Cir., 84 F. 2d 478, 481.

"(7-9) It is true that the dissolution of Murphy Company had tax consequences unfavorable to the Government. But as shown by the cases hereinabove referred to that does not authorize action under Section 45. Nor was dissolution illegal, improper or fraudulent. It was permissible corporate action which could have been taken by any corporation. If Murphy Company had sold its real estate to a different uncontrolled purchaser for cash, and used the cash to buy up its stock from Social Research or whomever its stockholders might be, and then dissolved, there would have been no impropriety in doing so, nor would Section 45 have been applicable. What it could properly do in a transaction with an uncontrolled taxpayer, it can also properly do with a controlled taxpayer without sub-

jecting itself to the provisions of Section 45. Mertens, Law of Federal Income Taxation, Sec. 46.69. The failure of the 1950 return to clearly reflect what the Commissioner considers is the actual net income of the taxpayer is not due to the control of one corporation over the other, but to the inherent nature of the accrual method of accounting, which, admittedly in this case, has been a recognized, approved method used by the taxpayer consistently over a period of many years. United States v. Anderson, supra; Sharp v. Commissioner, 6 Cir., 224 F. 2d 920, 924. We do not find in the transaction here under review the collusive or improper conduct between controlled taxpayers which is necessary to permit the Commissioner to make an allocation of net income different from what was properly and legally reflected by the books.

"The Tax Court and the Commissioner rely in part upon Jud Plumbing & Heating v. Commission, 5 Cir., 153 F. 2d 681; Standard Paving Co. v. Commissioner, 10 Cir., 190 F. 2d 330; and Central Cuba Sugar Co. v. Commissioner, 2 Cir., 198 F. 2d 214, certiorari denied 344 U.S. 874, 73 S.Ct. 167, 97 L.Ed. 677. No one of these cases involved the question of real estate taxes. The two cases first cited dealt with the proper accounting of income, and appear to be applications of the rule now well established in such cases as Gregory v. Helvering, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596; Helvering v. Clifford, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788; Helvering v. Horst, 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75; Commissioner of Internal Revenue v. Court Holding Co., 324 U.S. 331, 65 S.Ct. 707, 89 L. Ed. 981, and Commissioner of Internal Revenue v. Tower, 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670. The third case involved operating expenses, rather than real estate taxes accruing at a definite time as a matter of law and controlled by the rule in Mazruder v. Supplee, supra. For these reasons, we do not consider them applicable to the present issue.

"(10) The Commissioner also contends that Section 122 of the 1939 Code, 26 U.S.C.A. §122, under which the loss carry-back to 1949 is claimed, is limited to cases where the taxpayer has suffered a real economic loss, and does not authorize a loss carry-back where the loss is the result of bookkeeping entries, and is not a hardship case. Diamond A. Cattle Co., 21 T.C. 1; Wheeler Insulated Wire Co., 22 T.C. 580. This issue was not raised by the Commissioner at the hearing before the Tax Court and was apparently an afterthought presented in the Commissioner's brief filed with the Court at a later time. The Tax Court found it unnecessary to decide the issue, but referred to the two cases above cited as being against the taxpayer. The rulings in those cases may be justified under the particular facts involved in each case, where income and deductions were handled in such a way as to reflect a paper loss when actually no loss was incurred. In the present case there was a liability created by statute, which was just as real an obligation as any operating expense. It was properly entered on the books of the taxpayer as an accrued liability. United States v. Anderson, supra. Under the ruling in this case it remains so. Under taxpayer's approved accrual method of reporting net income or operating loss for income taxes it is a bona fide, legal liability, and the resulting loss as an actual loss. We find nothing in the wording of the statute that exempts from its operation legal losses properly proven and shown for income tax purposes by a recognized approved method of accounting. Although Section 122 is limited in its application in a number of ways by its express provisions, the limitations contended for by the Commissioner is not included.

"The Judgment of the Tax Court is reversed and the case remanded for further proceedings consistent with the views expressed herein."

COPY

No. 482

In the Supreme Court of the United States

OCTOBER TERM, 1960

TENNESSEE LIFE INSURANCE COMPANY, PETITIONER

v.

E. L. PHINNEY, DISTRICT DIRECTOR OF INTERNAL REVENUE AT AUSTIN, TEXAS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The District Court entered findings of fact and conclusions of law (R. 52–60).[1] The orginal opinion of the Court of Appeals (Pet. 27–37) and the *per curiam* opinion denying the taxpayer's petition for rehearing (Pet. 39) are not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on June 13, 1960 (Pet. 38). The order of the Court

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[1] Record references are to the separately printed record in the Court of Appeals.

of Appeals denying the taxpayer's petition for rehearing was entered on July 15, 1960 (Pet. 39). The petition for a writ of certiorari was filed on October 12, 1960. The jurisdiction of this Court is involved under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, in order to reflect clearly the true income of each organization, the Commissioner was authorized under Section 45 of the Internal Revenue Code of 1939 to allocate a deduction for *ad valorem* real estate taxes for the year 1953 between two organizations, both of which were owned and controlled by the same interests, in proportions that corresponded to the period of time each held title to the property during the year 1953.

STATUTE AND REGULATIONS INVOLVED

Section 45 of the Internal Revenue Code of 1939 provides:

> SEC. 45 [as amended by Sec. 128(b) of the Revenue Act of 1943, c. 63, 58 Stat. 21]. ALLOCATION OF INCOME AND DEDUCTIONS.
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, ap-

portionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. (26 U.S.C. 1952 ed., 45.)

Also involved is Section 39.45–1 of Treasury Regulations 118, the pertinent parts of which are set forth in the Appendix, *infra*, pp. 15–18.

STATEMENT.

The facts, stipulated in large part (R. 25–46) and as found by the District Court (R. 52–59), may be summarized as follows:

This suit was instituted by Tennessee Life Insurance Company (hereinafter called the "Life Company") as transferee of Tennessee Gas Building Corporation (hereinafter called "Building Corporation") to recover taxes paid on behalf of Building Corporation for the calendar year 1952 (R. 52–53). The suit is based upon a claim that Building Corporation sustained a net operating loss in 1953 which may be carried back and deducted in 1952 (R. 59). Whether this net operating loss was sustained depends primarily upon whether Building Corporation, which transferred the property involved on January 19, 1953, and was dissolved on January 23, 1953, was entitled to take a deduction for the amount of *ad valorem* taxes assessed against the property for the entire year 1953. (See R. 3–4, 57–58.)

Building Corporation was organized for the purpose of owning and operating the Commerce Building in Houston, Texas (R. 53). Throughout its exist-

ence it maintained its books of account and reported its taxable income on the accrual basis of accounting (R. 54). During each of its taxable years 1951 and 1952 it made monthly entries on its books of account for the *pro rata* estimated expenses for *ad valorem* taxes of each such monthly period. It prepared monthly statements of profit and loss, reflecting the entries made to its books of account, but did not publish or communicate these to any third party (R. 55).

Building Corporation and Life Company were both wholly owned subsidiaries of Tennessee Gas Transmission Corporation, which, on January 19, 1953, transferred all of the outstanding capital stock of Building Corporation to Life Company as a contribution to the capital of Life Company. On the same day, Building Corporation adopted a plan of complete liquidation and dissolution under which, on that date, it transferred all of its assets (including the Commerce Building), subject to its liabilities, to Life Company. Building Corporation was formally dissolved on January 23, 1953 (R. 56).

On January 19, 1953, just prior to its dissolution, Building Corporation entered on its books of account, as an estimated liability, the amount of $152,340 for *ad valorem* taxes for the calendar year 1953 on the Commerce Building and other properties which it held on January 1, 1953. In Texas real property is assessed as of January 1. The actual assessments of the taxes here involved, which were entered on the tax rolls by the appropriate officials subsequent to January 23, 1953, were in the amount of $143,570 and were not paid by Building Corporation (R. 56–57).

In its income tax return for the period January 1 to January 23, 1953 (hereinafter called the short year 1953), Building Corporation reported the rentals paid by Commerce Building tenants for the whole month of January, 1953, and claimed a deduction for *ad valorem* taxes for the entire calendar year 1953, in the amount of $143,570. The result, principally due to the deduction for *ad valorem* taxes, was a net operating loss which, in its 1952 tax return, Building Corporation sought to carry back and deduct against its income for that year (R. 57–58, 59).

Being of the view that Building Corporation's tax return for the short year 1953 did not truly reflect its taxable income for that period, the Commissioner adjusted the return so as to include only 18/31sts of the rentals in income and to allow a deduction for *ad valorem* taxes in the amount of only $7,080, which represented 18/365ths of the total taxes for the entire year or, in other words, the pro rata part for the 18-day period in 1953 prior to the transfer of the properties by Building Corporation to Life Company. As so adjusted, Building Company's return for the short year 1953 did not show a net operating loss (R. 58).

The District Court sustained the Commissioner's determination that these adjustments were necessary to reflect clearly Building Corporation's income for its short year 1953 (R. 58–59) and accordingly rejected Life Company's claim to a refund of taxes as transferee of Building Corporation (R. 59–60). The Court of Appeals, with one judge dissenting, affirmed the District Court (Pet. 27–37), holding not only that

the Commissioner had authority to make the adjustments on Building Corporation's return in order to reflect its true taxable income, but that in any event the *ad valorem* taxes had not accrued prior to the transfer of the properties by Building Corporation except to the extent that such taxes were allocable over the year by months under the usual method of accounting used by Building Corporation.

ARGUMENT

Among the grounds urged by the taxpayer in support of its petition are that the decision below is in conflict with the decisions of this Court in *Magruder* v. *Supplee*, 316 U.S. 394, and of the Sixth Circuit in *Simon J. Murphy Co.* v. *Commissioner*, 231 F. 2d 639. In our view the conflict with the decision of this Court does not exist and the conflict with the decision of the Sixth Circuit does not present a question of sufficient importance to require review of the case by this Court.

1. The taxpayer is in error in asserting (Pet. 9, 13–14) that the decision below is in conflict with *Magruder* v. *Supplee*, 316 U.S. 394. In that case the question was whether the vendee of property was entitled to a deduction, as a "tax paid," for its payment of state and city real estate taxes on the property which it had purchased. The answer depended, as the Court stated, on whether the taxes were imposed on the vendor or the vendee. Since the taxes had been assessed and had become due and payable prior to the sale of the property, from which it followed that the taxes had become a lien on the property

and that the vendor had become personally liable for their payment, the Court denied the claimed deduction on the ground that, in paying the taxes, the vendee had not discharged a liability imposed upon it, but had instead simply made an additional payment of purchase price by contractual arrangement with the vendor. Regardless of what pertinence that holding may otherwise have here—where the transfer, instead of being by way of a sale, was from one controlled corporation to another in a corporate liquidation—the question differs because of the addition of the element of the Commissioner's power under Section 45 of the Internal Revenue Code of 1939, *supra*, pp. 2–3, which specifically relates to controlled corporations. The court below held (Pet. 35–36) that this section authorized the Commissioner to allocate the Texas real property taxes involved here as between the taxpayer and its transferee, both of which were controlled corporations. As the court properly stated (Pet. 36), "There is nothing in the *Magruder* v. *Supplee* case that is inconsistent with this holding."

2. The taxpayer asserts that the decision below is in conflict with *Simon J. Murphy Co.* v. *Commissioner*, 231 F. 2d 639 (C.A. 6), "on two broad fronts." (Pet. 10.) One relates to the time when real property taxes should be accrued and therefore by whom they may be deducted on a sale of the property between unrelated taxpayers—a point on which *Murphy* held that, for 1950 Michigan real property taxes, accrual is proper as of January 1, 1950, and the court below

held that for Texas real property taxes a ratable accrual over the year is proper. Whether these holdings are in conflict in respect of the normal accrual time for real property taxes does not control here. The result reached by the court below is correct, regardless of the proper treatment of taxes in case of a sale between arms-length participants, if, under its "broader" basis for decision (Pet. 35), the court below was correct in holding that the Commissioner had power under Section 45 to allocate the Texas real property taxes between the two controlled corporations, the taxpayer and its transferee.

On this latter question, however, the decision below is admittedly in square conflict with *Murphy*. The Sixth Circuit held that the Commissioner's power of allocation under Section 45 in relation to corporations under common control is exercisable only when there is a showing of improper manipulation of income or deductions—that is, "collusive or improper conduct" (p. 645)—as between the controlled corporations. In contrast, the court below refused to restrict the Commissioner's power under the statute, holding (Pet. 35) that it "permits the Commissioner to deny to one of two related taxpayers such part of a deduction as is necessary to prevent the true taxable income to be distorted * * *".

3. Despite the conflict between the decision below and *Murphy* as to the scope of the Commissioner's power under Section 45, we submit, that, though the question is important, the nature of the conflict is not such as to require resolution by this Court.

(a) The decision below is correct and in accord with the weight of authority, whereas *Murphy* is an isolated decision. Section 45 does indeed give the Commissioner power to allocate income and deductions where there is "collusive or improper conduct," which *Murphy* concedes, but the court was incorrect in holding in *Murphy* (p. 645) that such conduct "is necessary" to permit the Commissioner to make an allocation under Section 45. Such a holding has the effect of restricting the Commissioner's power under the statute to making allocations which are necessary to prevent tax evasion, whereas the statute expressly confers the power of allocation where it "is necessary in order to prevent evasion of taxes *or clearly to reflect the income* of any of such [controlled] organizations * * *" (italics supplied). The Second Circuit has expressly stated that the power of allocation to reflect clearly income is "an independent reason for reallocation," that it "has been traditionally cited as such", and that the lower court's "assumption of the necessity of finding some ulterior motivation * * * was error." *Central Cuba Sugar Co.* v. *Commissioner*, 198 F. 2d 214, 215–216, certiorari denied, 344 U.S. 874. This is the rule which the court below obviously applied in the present case, as in prior cases.[2] It is a rule which other courts, in addition to the Second and Fifth Circuits, have implicitly applied

[2] *Jud Plumbing & Heating* v. *Commissioner*, 153 F. 2d 681 (C.A. 5); *Grenada Industries* v. *Commissioner*, 202 F. 2d 873 (C.A. 5), certiorari denied, 346 U.S. 819; *Willard-Waltermire, Inc.* v. *Campbell*, 255 F. 2d 433 (C.A. 5).

and, indeed, on occasion without expressly mentioning Section 45. See, e.g., *National Securities Corp.* v. *Commissioner*, 137 F. 2d 600 (C.A. 3), certiorari denied, 320 U.S. 794; *G. U. R. Co.* v. *Commissioner*, 117 F. 2d 187 (C.A. 7); *Standard Paving Co.* v. *Commissioner*, 190 F. 2d 330 (C.A. 10), certiorari denied, 342 U.S. 860. And, in fact, the right to reallocate income between controlled corporations even in the absence of improper conduct is clearly reflected in Treasury Regulations 118, Section 39.45–1, ¶(c), *infra*, pp. 17–18, in the provision that "the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits or allowances."

The taxpayer is not correct in asserting (Pet. 9, 14–16) that the decision below abrogates what it calls the "arm's length standard" prescribed in Treasury Regulations in relation to the application of Section 45. Although the taxpayer correctly quotes (Pet. 15) the Regulations, *infra*, pp. 15–18, the standard cannot properly be applied to give to related enterprises a tax treatment which would be accorded to independent entities dealing at arms length when the nature of the transaction is one peculiar to related corporations so that there is in fact no comparable factual situation between related corporations. In the present case, permitting the taxes for the entire year to be deducted by the Building Corporation would not place it and the Life Company in the same position as

unrelated taxpayers; on the contrary it would treat a coalescing of corporate enterprises through the medium of transfer of assets and liquidation as though it were an ordinary sale, and the parties thereto as though they were a vendor and vendee. Here the transfer of property occurred in connection with a liquidation, and thus was a transfer which could not take place between unrelated taxpayers. The result, if the taxpayer is allowed a deduction against its January 1953 income for the full year's real estate taxes, is that the taxpayer's net income is so distorted that it has a net loss for its short year 1953 when even under its own prior accounting practice it had taxable income. The justification for an allocation of the deduction for real estate taxes is that no such transfer or distortion of true income could result in a transaction between unrelated taxpayers. In the case of a sale of property the real property taxes would normally, if paid by the purchaser, be treated as an addition to the purchase price and there would in any event be income against which the deduction for real estate taxes would be offset.[3]

(b) The conflict between *Murphy* and the decision below in relation to the scope of the Commissioner's power under Section 45, although fundamental, should not require action by this Court. Many of the cases

[3] The Sixth Circuit failed to recognize this in *Murphy*. In fact, it apparently viewed (p. 645) the situation in the case of a liquidation as being no different, from a tax standpoint, than if the liquidating transferor sold the property to an unrelated taxpayer for cash and then used the cash to purchase its own stock.

applying Section 45 have involved situations where there was improper conduct on the part of the controlled corporations, and of course cases of that type are unaffected by the limitation which *Murphy* put on the Commissioner's power under Section 45. Thus, the conflict between *Murphy* and the decision below has a bearing only on those cases where there is a distortion of true income even in the absence of collusive or improper conduct, as may be the case on the liquidation of a controlled corporation. In the past relatively few such cases have given trouble. Since the decision below is supported by the weight of authority, it seems unlikely that *Murphy* will be followed by other courts, and in that circuit perhaps only in relation to accrual of real estate taxes, a question which will disappear under the present Internal Revenue Code. At any rate, there is at the present time no urgency for a review by this Court of the issue as to the scope of the Commissioner's power under Section 45; it appears that such review can await a further conflict with the decision below.

(c) On the narrower point of conflict between *Murphy* and the decision below—the application of Section 45 in relation to the deduction for real property taxes—the conflict will not be important for years subsequent to 1953.* Section 164(d) of the Internal Revenue Code of 1954 specifically provides for an

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*As to years prior to 1954, *Murphy* and the decision below appear to be the only cases in which the question of the Commissioner's power under Section 45 in relation to property taxes has arisen.

allocation of real property taxes as between the buyer and seller of property and Section 461(c)(1) permits an accrual basis taxpayer, at its election, to accrue such taxes ratably over the period of time to which they relate. These new Code provisions are consistent with the Commissioner's action in the present case. Section 461(c)(1) particularly, which of course, like Section 164(d), applies even to unrelated taxpayers, should eliminate any question of the propriety of a ratable allocation of real property taxes between controlled corporations—if, indeed, it ever becomes necessary for the Commissioner to make such an allocation under the 1954 Code.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1960.

APPENDIX

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.45–1. *Determination of the taxable net income of a controlled taxpayer.*—(a) *Definitions.* When used in this section:

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations in this part), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The terms "trade" or "business" include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations,

trades, or businesses owned or controlled by the same interests.

(6) The term "true net income" means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transallowances, resulting to the controlled taxpayer or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* (1) The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting net income, be-

tween or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 45 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate net income. If a controlled taxpayer is a party to a consolidated return, the true consolidated net income of the affiliated group and the true separate net income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Commissioner to apply such provisions. It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated net income under section 141.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions,

credits, or allowances. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

U.S. GOVERNMENT PRINTING OFFICE: 1968

Supreme Court of the United States

No. 482

IN THE

Supreme Court of the United States

October Term, 1960

TENNESSEE LIFE INSURANCE COMPANY, *Petitioner*

v.

R. L. PHINNEY, District Director of Internal Revenue at Austin, Texas, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY OF PETITIONER TO RESPONDENT'S BRIEF IN OPPOSITION

Argument

This case stands for the proper determination of "true net income" as between related taxpayers. If such "true net income" is to mean merely what the Commissioner of Internal Revenue shall say that it means in each case, then this case may be one of little importance. If on the other hand the restraint of a standard is to be imposed upon the

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Commissioner in the determination of such "true net income", then in its departure from such a standard this is a landmark case.

An appropriate summation of the purpose and intended extent of Sec. 45 of the Internal Revenue Code of 1939 (now Sec. 482, Internal Revenue Code of 1954) is found in the last sentence of Regs. 118, § 39.45-1. That concluding sentence reads as follows:

> "The authority to determine true net income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

Within that sentence may be found the rationale for the exercise of authority under Sec. 45, and the heretofore supposed limitations upon that exercise. The failure of the respondent to recognize this inherent standard in the application of Sec. 45 lies at the bottom of the entirety of the brief respondent has filed in this proceeding.

1. Respondent asserts that the decision below is not in conflict with *Magruder v. Supplee*, 316 U.S. 394 (1942). The purchaser who there acquired the properties and paid the advalorem taxes thereon after the date such taxes became a lien and the personal liability of his seller was in no sense related to the seller. The denial by this Court to that purchaser of a deduction for the taxes *fixed the standard* applicable to unrelated parties dealing at arm's length in a case involving ad valorem taxes. In prior cases reaching the same result as that reached by *Magruder v. Supplee*, that arm's length standard was held to be con-

trolling, even in cases involving a close relationship between the parties. In *Merchants Bank Building Co. v. Helvering*, 84 F. 2d 478 (8th Cir., 1936), after the taxes became a lien and the liability of the transferor, the property was transferred by the transferor corporation to another corporation in exchange for *all* of the capital stock of the latter, all pursuant to a tax free reorganization. Because the transaction was one between controlled taxpayers pursuant to a reorganization, it was argued that the ordinary rule denying a deduction for ad valorem taxes to a person other than the owner of the property on the lien date should not be applied. Holding for the Commissioner that the corporation which received the properties pursuant to the reorganization exchange was not entitled to any deduction for the taxes in question, the Court stated (p. 481):

> "Whether the transaction be called a sale, exchange, barter, or be given some other name, is not a matter of primary importance. Manifestly, the act did not have the effect of changing the inherent nature of the transaction. Viewing the transaction as a sale or exchange of property, the question in the final analysis is as to the right of a grantee to deduct as expenses taxes which he pays, but which were liens upon the property at the time of the transfer."

Closely related parties and tax-free transactions were similarly before the Court in the cases of *American Liberty Oil Co. v. Comm'r.*, 43 BTA 76, and *Texas Coca Cola Bottling Co. v. Comm'r.*, 30 BTA 736, cited and argued in petitioner's application for certiorari herein. The same result was reached in the case of *Brudno v. Comm'r.*, 138 F. 2d 770 (6th Cir., 1943), cited at page 645 in *Simon J. Murphy Co. v. Comm'r.*, 231 F. 2d 639 (6th Cir., 1956). In that case the Commissioner denied a deduction to a con-

trolling shareholder for any part of the current ad valorem taxes which such shareholder paid on properties which the controlled corporation distributed to him in liquidation after the taxes became a lien and the personal liability of such controlled corporation.

If the Courts shall now say that adherence to this standard of arm's length conduct between uncontrolled taxpayers is not required in a transaction between controlled taxpayers, then there is no conflict here between the decision below and that of *Magruder v. Supplee*; but if adherence to that standard is to be maintained, conflict between the decision below and the decision of this Court which fixed the nature of the arm's length standard in regard to the deductibility of the ad valorem taxes is inescapable.

2. The same circumstance is true regarding the conflict between the decision of the Court below and that in the *Murphy Co.* case as to the accrual date for ad valorem taxes. If the standard of arm's length conduct is to be applied, then the taxes may be accrued only by the party who owned the property on the date the taxes became a lien and the personal liability of such party. If such taxpayer together with the separate taxpayer with whom it is associated in control is to be considered as one taxpayer for purposes of the accrual, then the arm's length standard will have been abrogated.

The distortion to which the respondent refers in admitting the conflict between the decision of the Court below and that of the Sixth Circuit in the *Murphy* case does not exist if the arm's length standard is to be followed. That standard denies any deduction for taxes to a subsequent owner regardless of the effect of such denial on taxable income. If distortion exists in permitting Building

Corporation to take a deduction for the entirety of the taxes during its short year 1953, it is because a standard of "true net income" *other than that* of arm's length conduct between uncontrolled taxpayers is being applied to determine the meaning of true net income.

Obviously collusive conduct was not involved in the *Murphy Co.* case. The Court there stated, (p. 645), "In the present case the transaction was a bona fide one". We believe it is fair to assume the Court below in the instant case so viewed the transaction at bar.[1] In referring to the bona fides of the transaction, we do not in any sense suggest that a collusive intent is a prerequisite to the allocation of income or deductions under Sec. 45. Our position is simply that, where such an intent may appear, there may be more reason to ask whether things are what they seem. It was in such context that the Court in the *Murphy Co.* case stated (p. 645) that collusive conduct was "necessary" to permit the Commissioner, not as alleged by respondent in its brief (p. 9) to make an allocation under Section 45, but "to make an allocation of net income different from what was *properly and legally* reflected by the books". The result which was "properly and legally reflected by the books" in the *Murphy Co.* case was simply the application to the facts there involved of the arm's length standard of conduct between uncontrolled parties applicable to those facts.

3. The importance of this case is simply whether a standard of arm's length conduct is to be adhered to in transactions between controlled taxpayers, or whether a-

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[1] See statement (Pet. 37) of Judge Cameron, dissenting, stating that "There is no contention that the transaction here involved was not bona fide in every respect and that it did not serve a useful purpose"

the Court below stated "On the broader ground, we are satisfied that the right of the Commissioner to apportion or distribute deductions or income under Sec. 45 is not restricted to such apportioning or distribution as would be permissible for two unrelated taxpayers under existing taxing statutes." Put more simply is "true net income" to be in each case what the Commissioner says it is to be, or is there to be superimposed the restraint of some appropriate standard on what the Commissioner may say "true net income" is to be.

The standard here sought was imposed in each prior case in which deductibility of taxes as between related parties was considered. Certain it is that the Commissioner in each such case was arguing the applicability of that standard. But if faith of the taxpayers generally in the system, which is conceded to be a prerequisite to the continued success of our revenue system, is to be maintained, then the Commissioner should not be allowed to insist on the standard when it is to his benefit and depart from it in those instances in which he conceives the immediate tax result to be detrimental to the revenues.

The respondent then finally argues that adherence to the standard here urged is in any event not pragmatically important because a question will only infrequently arise on the facts at bar. This argument begs the principle, but nevertheless let it be examined. The exact question will arise each time there is an exchange or a distribution of property which does not amount to a *sale* of such property.

Where the Internal Revenue Code of 1954 is applicable Sec. 164 (d)(1) of that Code permits apportionment of ad valorem taxes on realty between sellers and purchasers, but under the terms of such statute such apportionment is limited to circumstances where the realty is *sold*. Simi-

larly, Sec. 461 (c) of the 1954 Code is of no benefit to a party acquiring property after the taxes thereon become a lien and the personal liability of the prior owner. That section permitting accrual of real property taxes over the period to which they relate is specific in its allowance of such privilege only to a person who "incurs" real property taxes. This Court in *Magruder v. Supplee* (at pp. 398 and 399) made it clear that no "taxes" were *incurred* by a subsequent owner taking the property after the taxes became a lien and the personal liability of a predecessor in title. It is for that reason that sub-paragraph (B) of Sec. 164 (d) (1) became necessary so as to treat expressly the portion of the taxes allocable to the period during which the property is held by the purchaser as being taxes "imposed on the purchaser". No similar language occurs in Sec. 461 (c) which would alleviate the limitation of that section to one who "incurs" the taxes.

Further, it is not true that (Res. Br. p. 10), "the standard cannot properly be applied to give to related enterprises a tax treatment which would be accorded to independent entities dealing at arm's length (because) the nature of the transaction is one peculiar to related corporations so that there is in fact no comparable factual situation between (un)related corporations."

It not infrequently occurs that a minority stock interest, being in no sense "a controlling interest" is liquidated by a distribution of property in exchange for the surrender for cancellation of the stock of that minority holder. Under *Magruder v. Supplee*, that former minority stockholder will not be entitled to claim any deduction for taxes on the distributed property for which a lien and liability had affixed prior to the date of distribution. It also not infrequently happens that acquisition of corporate properti

is obtained through purchase of the capital stock of a pr corporate owner and immediate distribution thereafter its properties in liquidation. Such a transaction would no sense represent one between controlled taxpayers, be under *Magruder v. Supplee*, the acquiring corporate own could secure no deduction for taxes it might pay on th properties distributed in liquidation after a lien and li bility for the taxes thereon had been affixed. And, as hereinabove shown the standard of *Magruder v. Supplee* has bee applied in all cases of non-taxable exchanges between re lated taxpayers. The standard to which petitioner reques adherence is a *true* standard.

Conclusion

Petitioner respectfully submits that this case presents significant question in regard to the administration of th revenue laws as between controlled taxpayers, and that th question is one which this Court has not considered. Petitioner respectfully submits that "on the broader front" the orderly administration of the revenue laws demand that the Commissioner as well as taxpayers adhere to standard in the determination of taxable income.

Respectfully submitted,

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November, 1960

Certificate of Service

I hereby certify that I have this day in the manner hereinbelow stated served each of the following persons with a copy of this Reply of Petitioner, as required under Paragraph 2 of Rule 33.

1. Solicitor General, Department of Justice, Washington 25, D. C., by United States Airmail deposited at Houston Texas.
2. Hon. Charles K. Rice, Assistant Attorney General, Department of Justice, Washington 25, D. C., by United States Airmail deposited at Houston, Texas.
3. Hon. Russell B. Wine, United States Attorney, Western District of Texas, San Antonio, Texas, by United States Airmail deposited at Houston, Texas.

Dated this ____day of November, 1960.

ROBERT K. JEWETT
Attorney for Petitioner